An initial response to the Pensions White Paper

by Carl Emmerson, Gemma Tetlow and Matthew Wakefield

Responding to today’s publication of the Pensions White Paper Gemma Tetlow, a Research Economist at the IFS, said: “Today’s White Paper confirms that the Government wishes to restore the link between the Basic State Pension and average earnings, and also introduce measures that would boost the coverage of state pensions. On average women would be big gainers from both these proposals. More generally in the long-run, if implemented, the package of proposals would simplify the extremely complicated UK state pension system”.

Matthew Wakefield, a Senior Research Economist at the IFS added “Despite the planned increase in the State Pension Age, increased borrowing or taxation is expected to be required to finance these proposals. A risk is that a future Government decides to allocate the necessary resources to other causes (such as lower taxes or higher spending on public services) rather than earnings index the Basic State Pension. The Pensions Commission proposed that the earnings link be restored in 2010–11, but the Government has already decided that this would be too expensive and pushed it back for at least two years. Individuals planning ahead might be best advised to consider that there is no guarantee that the Basic State Pension will remain linked to earnings as envisaged in this White Paper.”

How much would the reforms to state support for pensioners cost?

The Government currently spends 5.2% of national income on state pensions and the Pension Credit, and the Department for Work and Pensions (DWP) forecasts that the reformed system would, in 2050–51, cost 6.7% of national income, with all of the forecast increase coming after 2020–21. This 1.5% of national income increase in state spending on pensions is slightly higher than the 1.1% of national income increase in cost that the DWP forecasts would be required under the current system (assuming that the Basic State Pension is indexed in line with prices and that the Pension Credit Guarantee is indexed in line with earnings).

The increase of 1.5% of national income by the middle of this century is equivalent to £18.6 billion in today’s terms, equivalent to £270 per person per year. If we are now sure that future tax increases are required then it might be more appropriate to increase them sooner rather than later so that the change is less abrupt. Smoothing tax rates in this manner might be more efficient. The abolition of contracting out rebates would cover some but not all of this increase.
The cost of increasing the generosity of state pensions is estimated by the DWP to be 1.7% of national income in 2050–51 (£21.1 billion). This is offset by a 1.0% of national income (£12.4 billion) cut from the increase in the State Pension Age (SPA). Forecast expenditure on the Pension Credit is reduced by 0.2% (£2.5 billion) of national income compared to what it would have cost in 2050–51 (assuming that the Government’s long-standing aspiration for earnings indexing the Pension Credit Guarantee was met). The White Paper proposals add 0.5% of national income to public spending in 2050–51, on top of the public spending projected under the current system. This is £6.2 billion more than the estimated cost of the current system in 2050–51, or an extra £90 per person in that year.

The costs of the two systems are shown in figure 1 below. Unfortunately comparable figures from the system proposed by the Pensions Commission are not available.

**Figure 1** DWP projections for the level of public spending on state pensions and the Pension Credit, under both current and proposed system.

Who would gain from the increases in generosity of state support?
Judging who would gain and lose is complicated by the fact that we do not know how all of the £18.6 billion increases in spending on state pensions and the Pension Credit are to be financed.

In the near term the big gainers from today’s announcement are recipients of the Pension Credit Guarantee (who, aside from those not claiming the benefits to which they are entitled, are the poorest pensioners). Previously the Government had only committed to earnings indexing this payment until 2008, although it had a long-standing aspiration to continue this in the medium term. Today the Government committed to earnings indexation of the Pension Credit Guarantee beyond April 2008.
The extension of the Financial Assistance Scheme would benefit those individuals who receive new support. These individuals are all within 15 years of their normal pension age and suffered losses in their private sector defined benefit pension arrangements prior to the introduction of the Pension Protection Fund.

Many of those without complete entitlement to the Basic State Pension would gain from the reforms to the National Insurance credits, and the reduction in the number of years of contributions needed to qualify for a full Basic State Pension. In particular this would benefit many women aged over 45 who have spent periods out of the labour market, but were unable to benefit from Home Responsibilities Protection which only covers whole years of certain formal caring since April 1978.

Those who expect to live for longer would also, on average, benefit more from the earnings indexation of the Basic State Pension. As with the change to credits this would, on average, benefit women more than men. It would also on average benefit richer individuals more than poorer ones as they also have higher life expectancies. The generosity of the Basic State Pension relative to average earnings over time is shown in Figure 2. The standard Basic State Pension is currently worth £84.25 a week (which is 15.5% of average earnings) to a single pensioner. By 2050–51 under price indexation this would be worth 6.5% of average earnings (which is just £35.25 in current earnings terms). By 2050–51 under earnings indexation from 2010–11, as proposed by the Pensions Commission, it would be worth 14.6% of average earnings (£79.39 in current earnings terms), whereas under earnings indexation from 2012–13 or 2015–16 it would be worth 14.1% or 13.3% of average earnings respectively (£76.31 or £71.91 in current earnings terms respectively).
Who would lose from the reductions in generosity of state support?

The main cost saving measure is the planned increase in the SPA.

The rationale for increasing the SPA is that individuals are living longer. The White Paper believes that the increased SPA would “share the growth in life expectancy between time spent in work and time spent in retirement”. However if some of the additional years of life are unhealthy then the proportion of healthy life spent in receipt of the state pension could fall over time.

Currently only around one-third of men are in work when they reach the SPA, and this illustrates why it is not clear how many more individuals would work beyond age 65 if the SPA were increased after 2020. The individuals who would be most likely to continue working might well be those who are financially less well off, and thus unable to afford to retire until they can claim state pensions. While continuing to work might increase the incomes of such individuals, they may consider themselves worse off if they would prefer not to have to work.
Individuals who could be made financially worse off by the measure would be those who were unable to take state pensions, but also unable to find work. The Pensions Commission proposed that these people could be helped by allowing them to claim Pension Credit Guarantee from age 65. The Pension Credit is more generous than the means-tested benefits that are available to (healthy) younger individuals. However today’s White Paper states that “[the age at which individuals qualify for the Pension Credit in future] is an issue that must be considered nearer the relevant time in the light of the available evidence about inequalities in life expectancy and trends in working among older people.” A future government might not be prepared to decouple the age at which state pensions and the pension credit can be claimed, and would instead choose to increase the qualification age for the pension credit – if so those aged 65, 66 and 67 on low incomes would lose.

In its 2002 pensions Green Paper the Government recognised the potential distributional impact of increasing the SPA, and ruled out a universal increase in the SPA.

There are also technical changes to the indexation of certain parameters within the Pension Credit Savings Credit and the State Second Pension. Some low to middle income pensioners would get less Pension Credit Savings Credit, while higher earning individuals would accrue a smaller entitlement to the State Second Pension as this is to be moved to a flat rate system quicker than implied by the current indexation. At least some of the individuals who lose from these specific reforms would find that their state income after the SPA is still higher as a result of the other changes such as the more generous Basic State Pension.

**What are the principles behind the proposed private pension reforms?**

The White Paper confirmed all employees would be automatically be members of a new private pension scheme, unless their employer automatically enrolls them into a private pension that would be expected to provide an at least equally generous retirement income. Individuals would be able to choose actively to opt out of this scheme. Individuals and their employers would then have the option to increase their contributions (subject to an annual cap).

The “presumption” involved in these arrangements aims to utilise inertia (whereby people follow the default option) to increase the number of people saving in pensions. Evidence from the United States suggests that it would boost coverage, and the fact that employers would have to contribute would increase the cost of choosing to leave the new private pension scheme.

**What would be the effect of the new private pension scheme on employers and employees?**

Many employers do not currently offer their employees a pension contribution as generous as the required contribution proposed. For these employers, if at least some of their employees choose to stay in the new private pension scheme, their labour costs would rise, assuming that there is no offsetting fall in wages. For
employers who do currently offer all their employees an equally generous pension, this policy would not affect their labour costs if membership of this scheme does not change. However, if inertia results in more employees belonging to the pension scheme (when the default position is to be opted into the scheme), even these employers could see a rise in their labour costs. In the medium term, employers might be able to offset the additional labour cost introduced by this scheme for example by offering lower wage increases or a less generous pension scheme (although not less generous that the minimum set by the Government). If wages were reduced then those who did not wish to join the new private pension scheme would lose out.

There is a danger that employers (faced with having to make a 3% contribution for every employee who opts to stay in the new private pension scheme) could encourage employees to opt out, perhaps offering alternative, less costly inducements to do so. Alternatively employers may seek to employ more individuals who have an incentive not to currently save in a pension. This could include those with high debts or those with currently relatively high consumption needs.

If presumption did induce more employees to contribute to a private pension then the new members could include two types of people. First, those for whom saving in a private pension is an appropriate decision – this group of people would gain. Second, those for whom saving in a private pension is not an appropriate decision, for example if they have pressing consumption needs – this group of people would lose. In addition the US evidence also suggests that though more people would save in pensions as a result of auto enrolment the existence of a default contribution level means that some would save less than they would otherwise have done.

The contributions to the new private pension scheme would be centrally collected, which would reduce the administrative costs of collecting pension contributions below that of typical individual private pensions. This would leave some employees better off.

ENDS

Notes to editors: